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Nos. —, —,

In the Supreme Court of the United States

OCTOBER TERM, 1928

THE UNITED STATES, PETITIONER

v. 128

AMERICAN CAN COMPANY

THE UNITED STATES, PETITIONER

v. 129

MISSOURI CAN COMPANY

THE UNITED STATES, PETITIONER

v. 130

DETROIT CAN COMPANY

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the United States, prays that writs of certiorari issue to re-

view the judgments of the Circuit Court of Appeals for the Third Circuit entered in the above-entitled cases on March 5, 1929, affirming the judgments of the District Court of the United States for the District of New Jersey.

STATEMENT

The American Can Company and its subsidiaries, Missouri Can Company and Detroit Can Company, respondents herein, are engaged in the business of manufacturing and selling cans and other containers. They kept their accounts, made their returns, and paid their income and excess-profits taxes for the year 1917 totaling $3,266,499.86 upon the accrual basis. (R. 3–4, 174–175, 194–195, 211–212, 228–229, 246–247.) Additional assessments were thereafter made against the parent company totaling $1,953,480.79 (R. 5), and were paid to the then collector William H. Edwards, who had collected the original assessments. Thereafter a final audit resulted in further additional assessments which have given rise to this litigation based upon the following facts:

Respondents, in the conduct of their business, were required to keep on hand large stocks of tin plate, which was the most important material used by them. (R. 194, 229.) The market price of tin plate rose sharply in the early part of 1917 from $3.60 per base box to $7. Respondents took advantage of this sharp increase in value of stocks on hand by writing up as of January 1, 1917, to

$7 per base box, their opening inventories of tin plate, which had cost them but $3.60 per box, and transferring so much of the inventory write-up as was claimed to represent respondents' normal stocks of tin plate to the so-called "inventory constant" accounts set up for the first time in that year.

[The above facts showing the manner in which respondents' books of account reflected this write up of tin plate in inventory and transfer to their "inventory constant" accounts, and the reasons therefor, are not included in the findings made by the District Court, but are supported by uncontradicted evidence in the record (R. 50, 81, 83) which has been adopted by the Circuit Court of Appeals in its opinion (R. 261–262) as proven facts.]

This had the effect of increasing the cost of goods sold as returned by the respondents and resulted in an understatement of net income to the extent of the amounts credited to their respective "inventory constant" accounts. The net income of the American Can Company was thus understated by $4,722,500 (R. 13), the net income of the Missouri Can Company by $168,500 (R. 14), and the net income of the Detroit Can Company by $70,000 (R. 14).

The Commissioner of Internal Revenue eliminated this artificial inflation of the cost of goods sold (R. 13–14), increased respondents' net income by the amounts in the "inventory constant" accounts, and made further additional assessments as follows: American Can Company $3,383,481.46 (R.

6); Missouri Can Company $10,110 (R. 195); Detroit Can Company $4,200 (R. 230). Respondents filed claims to abate such further additional assessments and filed claims for refund of so much of the taxes theretofore paid as exceeded what they contended was their true tax lability computed on the cash receipts and disbursements basis. The grounds set forth in the claims, which are also the grounds upon which these suits are based, were that the Commissioner, in correcting the valuation of inventories used in the computation of the cost of goods sold, rejected the basis upon which their accounts were kept and their returns filed, and that as the result of the action of the Commissioner, they became entitled under the provisions of Section 13 (d) of the Revenue Act of 1916, to have their income computed on the cash receipts and disbursements basis, and that on such basis, respondents' tax liability was not only less than that computed by the Commissioner but was less by $2,719,159.16 (R. 162–163) than the taxes paid by them on their returns as filed.

The District Court for the District of New Jersey upheld these contentions (R. 160–165) and allowed respondents a recovery of the amount of taxes paid to William H. Edwards, Collector, in excess of the amounts found by the court to be their tax liability computed on the cash receipts and disbursements basis. (Exhibit P–7 (R. 128), Exhibit

P–8 (R. 149, 150), Exhibit P–10 (R. 153); R. 181, 214, 249.)

Respondents' income on the cash basis adopted by the court was computed without the use of inventories and does not correctly reflect the gross amount of income and the cost and expenses properly attributable to the production of that income. It amounts to no more than the statement showing the excess of income receipts over income expenditures, each class having no necessary relation to the other. The District Court has not made findings that the computation of income on the cash basis adopted by it was arrived at without the use of inventories, but this fact was established by the testimony of one of respondents' witnesses (R. 84), and requests for such a finding were made by the Government in each case and were denied (R. 170, 207, 242).

The cases were tried together in the District Court. Upon the conclusion of the trials in the District Court the Government made timely motions for judgments in its favor, which were denied and exceptions duly taken and allowed. (R. 99.) Requested findings of fact were made and filed by the Government in each case, and exceptions duly taken and allowed to the court's refusal to make the findings requested. (R. 166–172, 203–209, 238–244.) Timely exceptions were also taken and allowed to the findings of fact and conclusions of law as made and filed by the District Court in each case. (R. 174–181, 211–214, 246–249.)

The Circuit Court of Appeals for the Third Circuit affirmed the judgments of the District Court in an opinion reported in 31 F. (2d) 730, and the United States by this petition seeks a review of that action by this Court.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

I. In holding that the action of the Commissioner in these cases amounted to a rejection of the accrual basis upon which basis the respondents kept their accounts and upon which their returns were made so as to entitle respondents to have their income for the year 1917 computed on the basis of cash receipts and disbursements.

II. In holding that the respondents' income computed upon a cash receipts and disbursements basis could be correctly determined without showing by the use of inventories the cost of goods sold.

III. In holding that respondents were entitled, as a matter of right, to have their taxes computed on the basis of cash receipts and disbursements in the absence of a finding that the accrual basis, which the Commissioner is said to have rejected, did not in fact reflect their true income.

REASONS FOR GRANTING THE WRITS

The cases are of vital importance to the Government and to the public, not only because of the large amounts involved, but also because they present an important question of Federal law of general application as to the extent to which the Com-

missioner of Internal Revenue may go in the correction of returns without departing from the statutory precept regarding the accounting basis upon which returns must be made.

If the decision of the Circuit Court of Appeals, that the *mere* correction by the Commissioner of respondents' inventory valuation of tin plate amounted to a rejection of the basis upon which respondents' books of account were kept and their returns filed is allowed to become settled law, much confusion will arise in the future as to how far the Commissioner may go in correcting returns filed in accordance with a particular system of accounting so as to prevent a taxpayer from becoming entitled to have his income computed under the cash receipts and disbursements basis.

The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Aluminum Castings Co.* v. *Routzahn,* 31 F. (2d) 669, wherein the Commissioner's right to make adjustments in a return on the accrual basis filed under Section 13 (d) of the Revenue Act of 1916, here involved, was upheld.

The decision of the Circuit Court of Appeals is also in conflict with the decision of this Court in *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 179, in that respondents' income on the so-called cash receipts and disbursements basis, which the Circuit Court of Appeals adopted as correct, was arrived at without regard to inventories. The Circuit Court

of Appeals in thus determining net income as the excess of income receipts over income expenditures, without taking into consideration the cost of goods sold which produced the income has not followed the rule laid down by this Court in the cases of *United States* v. *Anderson,* 269 U. S. 422, and *American National Co.* v. *United States,* 274 U. S. 99. In those cases this Court has recognized that the basis of cash receipts and disbursements will not properly reflect the true income of manufacturing and mercantile concerns.

The decision of the Circuit Court of Appeals is contrary to the decisions of the District Court for the Southern District of New York in four cases (now pending in the Circuit Court of Appeals for the Second Circuit) brought by the respondent, American Can Company, and its subsidiaries, against Bowers, Collector, to recover further additional assessments paid by the same taxpayer for the same taxable year and raising precisely the same questions.

Wherefore, it is respectfully submitted that this petition for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Third Circuit should be granted.

CHARLES E. HUGHES, JR.,
Solicitor General.

JUNE, 1929.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the District Court for the District of New Jersey (R. 160–165) is reported in 20 F. (2d) 970. The opinion of the United States Circuit Court of Appeals (R. 261–263) is reported in 31 F. (2d) 730.

JURISDICTION

The judgments of the United States Circuit Court of Appeals were entered on March 5, 1929. (R. 263–264.) The jurisdiction of this Court rests on the provisions of Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the correction by the Commissioner of Internal Revenue of the valuation of the inventories of tin plate in respondents' returns made on the accrual basis constituted such a rejection of the basis on which respondents' accounts were kept as to render it necessary under Section 13 (d) of the Revenue Act of 1916 to compute the income on the basis of cash receipts and disbursements.

2. Assuming because of the action of the Commissioner respondents are entitled to have their income computed on the basis of cash receipts and disbursements, can respondents' income be cor-

rectly computed on such basis without the use of inventories?

3. Assuming that the Commissioner in changing the valuation of respondents' inventories has rejected respondents' accrual basis of accounting, does such a rejection made by the Commissioner herein in determining that an additional assessment was due for the year 1917 entitle respondents to a recovery of taxes paid on their returns filed on the accrual basis in the absence of a finding that such accrual basis did not reflect their true income?

STATUTES AND REGULATIONS INVOLVED

The pertinent portion of the Revenue Act of 1916, c. 463, 39 Stat. 756, 771, reads:

> SEC. 13. (a) The tax shall be computed upon the net income, as thus ascertained, * * *;
>
> (d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned; * * *.

The pertinent portion of the Revenue Act of 1917, c. 63, 40 Stat. 300, 305, reads:

SEC. 206. That for the purposes of this title the net income of a corporation shall be ascertained and returned * * * (c) for the taxable year upon the same basis and in the same manner as provided in Title I of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, as amended by this Act * * *.

Treasury Decision No. 2609 promulgated December 19, 1917:

(1) For the purposes of income and excess-profits tax returns, inventories of merchandise, etc., and of securities will be subject to the following rules:

A. Inventories of supplies, raw materials, work in process of production, and unsold merchandise must be taken either (a) at cost or (b) at cost or market, whichever is lower, provided that the method adopted must be adhered to in subsequent years, unless another be authorized by the Commissioner of Internal Revenue.

B. A dealer in securities who, in his books of account, regularly inventories unsold securities on hand either (a) at cost or (b) at cost or market price, whichever is lower, may, for purposes of income and excess-profits taxes, make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inven-

toried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner of Internal Revenue.

C. Gain or loss resulting from the sale or disposition of assets inventoried as above must be computed as the difference between the inventory value and the price or value at which sold or disposed of.

(2) In all other cases inventories must be taken at cost or at value as of March 1, 1913, as the case may be.

STATEMENT

A statement of the facts and the errors relied on will be found in the petition.

ARGUMENT

The amount of tax for 1917 in dispute between the American Can Company and its subsidiaries and the United States is approximately $8,000,000. The entire dispute arises out of the Commissioner's treatment of the inventory account. A part of the disputed taxes in a sum approximating $4,000,000 was paid to a collector in the District of New York who was no longer in office at the time these suits were brought, and a part was paid to the incumbent collector in the said district. These cases were instituted in New Jersey to recover a part of the taxes paid to the late collector on the original returns and on the additional assessment made by the Commissioner September 21, 1920. (R. 5.)

Similar suits brought against Collector Frank K. Bowers in the Southern District of New York to recover the further additional assessments (R. 6, 195), which were paid to him under protest upon the denial of the claims in abatement (R. 7, 195–196), and which thus involve the same tax liability of the same taxpayers, for the same year, and raise precisely the same questions, have resulted in judgments in favor of the Collector. The New York District Court held that the Commissioner in his final audit did not reject the accrual basis but correctly determined respondents' true income on the basis upon which their accounts were kept. The very anomalous situation is thus presented of the action of the Commissioner, with respect to the same tax liability, of the same taxpayers, for the same tax year, being valid in one jurisdiction and invalid in another. The opinion of the District Court is not officially reported as yet and is printed as an appendix to this brief. The New York judgments are now pending on appeal before the Circiut Court of Appeals for the Second Circuit and have been set for argument on October 7, 1929.

The cases here involve the power of the Commissioner to make corrections in returns filed under Section 13 (d) of the Revenue Act of 1916. It is the contention of the petitioner that the corrections made by the Commissioner in these cases in no wise affected the basis upon which the income was returned, and that his action did not give respond-

ents the right to have their income computed on the cash receipts and disbursements basis as was held by the courts below.

The respondents made their returns for income and excess profits tax purposes on what is called the accrual basis, treating accounts receivable as equivalent of receipts and accounts payable as equivalent of disbursements, and they valued their inventory on the basis of cost or market value, whichever was lower, except for their normal stocks of tin plate, which they valued at a constant figure irrespective of change in market value. This was accomplished by an arbitrary write-up in January, 1917, of opening inventory of tin plate costing $3.60 per box to current market value of $7 per box and by transferring so much of the write-up as covered normal stock of tin plate to an "inventory constant" account opened for the first time in that year.

This arbitrary valuation of the inventory of tin plate by respondents resulted in an understatement of respondents' net income, which was arrived at in violation of the provisions of Treasury Decision No. 2609, promulgated on December 19, 1917, which governed returns filed for the year 1917, and required that all goods in inventory be carried at cost or market, whichever was lower.

The Commissioner, in his audit of respondents' returns, adjusted the inventory accounts to conform to the requirements of this valid regulation (*United States* v. *Kemp,* 12 F. (2d) 7; certiorari

denied, 273 U. S. 703), and correctly determined respondents' gross income and expenses incident to the production of that income. *United States* v. *Anderson,* 269 U. S. 422; *American National Co.* v. *United States,* 274 U. S. 99.

The decision of the Circuit Court of Appeals rests on the view that respondents' method of valuing its tin plate in its inventories gives rise to a statutory basis of keeping accounts distinct in itself and different from a strict accrual basis. This is made clear from its decision, wherein that court said (R. 262):

> The stock other than tin plate was valued at its cost or market price, whichever was lower, and the reason why the basis used by the plaintiffs in making their return did not reflect their true net income was because of this "inventory constant," $7.00 per box, used in making the inventory of the stock of tin plate regardless of cost or market value. When this was changed and $3.60 was used instead, the basis of making their inventory was changed so that the cost of finished products was decreased and the net income increased. The change by the commissioner was not the mere or incidental change or correction of a figure in a system, but the change of a system from one basis to a different basis.

Based upon this view the Circuit Court of Appeals has held that the Commissioner's action in correcting respondent's valuation of tin plate in

inventory amounted to a rejection of the basis upon which their accounts were kept and their returns filed, and that the basis actually used by the Commissioner in redetermining the tax of respondents for the year 1917 was not authorized by the Act of 1917 (1916 Act as amended) and was contrary to law. In conclusion that court held that if the basis on which returns were made did not reflect true income, which it assumes to be the case because of the Commissioner's action in correcting it, the Commissioner must use the cash basis.

Under this construction of Section 13 (d) the Commissioner in most cases will be compelled to accept returns as filed without change or correction and compute taxes on the income *as returned,* otherwise taxpayers will become entitled to have their income computed on the cash receipts and disbursements basis, which basis, as was recognized by this Court in the cases of *United States* v. *Anderson, supra,* and *American National Co.* v. *United States, supra,* will not properly reflect the true income of manufacturing and mercantile concerns. It is therefore submitted that the Circuit Court of Appeals has misconstrued the true meaning of the provisions of this section.

The term "basis" as used in Section 13 (d) has regard to the principle on which accounts are kept, that is, as to when income is deemed to have been received and disbursements deemed to be made. It has nothing whatever to do with the number or vari-

ety of accounts used by a corporation in its bookkeeping methods nor with the opening of new accounts. It refers to the theory and practice upon which accounts are kept—that is, whether income and expenditures are treated as having been received and disbursed only when cash is actually received and disbursed or whether receipts are treated as received when they accrue and disbursements treated as made when they are incurred. That Congress had these two fundamental bases of accounting primarily in mind when it enacted subdivision (d) of Section 13 is evident from the report of the Ways & Means Committee of the House (House Report No. 922, Sixty-fourth Cong., 1st sess.) wherein it is said (p. 4):

> * * * As two systems of bookkeeping are in use in the United States, one *based* on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the *basis* selected clearly reflects the income. (Italics supplied.)

It is obvious that if one corporation values its inventory on the basis of cost or market, whichever is lower, while another company in the same business in making up its inventory uses a different valuation, it would be absurd to hold because of such difference in the method of valuing the goods that those corporations employed different bases of

accounting. It would likewise be unsound to hold that if the Commissioner were to change the values ascribed by the second company to its inventory to comport with cost he thereby changed the basis on which the taxpayer kept its books and made its return.

In this case respondents treated the "inventory constant" accounts as a present expense chargeable against current income; the Commissioner (following *United States* v. *Anderson, supra,* and *American National Co.* v. *United States, supra*), treated it as a reserve set up out of current income to meet anticipated future losees not sustained in the current year. Whichever treatment is proper, it is obvious that the basis upon which the accounts were kept and returns made was not changed. All that the Commissioner did was to disallow as a deduction an item of alleged expense shown by respondents' books which was not in fact incurred in the taxable year. This obviously was not a change of respondents' basis, but merely a correction of the returns to conform to that basis. This is clear from the fact that the Commissioner's action did not result in any inconsistent treatment of any of the items in respondents' returns, all of the items being treated throughout on the accrual basis. The question here does not involve a change of the taxpayer's books or accounts but merely an interpretation of them for the purposes of determining how much income they show to have been earned during the year 1917.

A similar question was involved in the case of the *Aluminum Castings Co.* v. *Routzahn,* 31 F. (2d) 669, wherein the Circuit Court of Appeals for the Sixth Circuit, in a well-reasoned opinion, held adversely to the decision of the Circuit Court of Appeals herein. In that case the court rejected taxpayer's contention that it kept its books of account and filed its return on the cash receipts and disbursements basis and was entitled to have its income computed on the basis on which it kept its accounts and, holding that taxpayer's returns for the years 1916 and 1917 were made on the accrual basis, approved the action of the Commissioner in disallowing for the year 1917 a deduction for munitions taxes paid in 1917 but which had accrued in 1916. Since taxpayer in that case had adopted the method of treating accounts payable as expenditures as of the time of entry upon its books rather than when the same accrued, this bookkeeping departure from the strict accrual basis created a system just as distinctive as that created by the method in which respondents valued their tin plate in their inventories.

But if the income is to be determined on the basis of cash receipts and disbursements, it is not properly disclosed by respondents' calculation. In that calculation the deduction taken for expenses includes amounts paid for tin plate during the year regardless of whether such tin plate entered into the manufacture of the products for which payment was received during that year. In deter-

mining the gain from a cash transaction, the cost of goods sold must be deducted. *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179. This was further recognized by this Court in the cases of *United States* v. *Anderson, supra,* and *American National Co.* v. *United States, supra,* wherein this Court held that the income of manufacturing and mercantile corporations could not be properly computed on the cash basis.

The case of *Doyle* v. *Mitchell Brothers Co., supra,* arose under the Corporation Excise Tax Act of August 5, 1909, which provided for the return of income on a cash receipts and disbursements basis only. The Court there said that the gross income of manufacturing companies "should consist of the difference between the price received for the goods as sold and the cost of such goods as manufactured," the cost to be ascertained by an addition of a charge to the account of goods as manufactured during the year of the sum of the inventory at the beginning of the year and a credit to the account of the sum of the inventory at the end of the year.

On a cash basis moneys spent for materials not used or sold during the year are not ordinary and necessary expenses but are investments in capital items and can not be deducted under the statutory provision any more than could the cost of the factory building. It is, therefore, necessary in computing income on a cash receipts and disbursements

basis to take into account the increase or decrease in inventory during the year.

In any event it is submitted that the judgments herein are fatally defective in that there are no findings either of fact or law that the basis on which respondents kept their accounts and made their returns for the year 1917 did not reflect their true income. Section 13 (d) authorizes a corporation "keeping accounts upon any basis other than that of actual receipts and disbursements" to "make its return upon the basis upon which its accounts are kept" if such basis clearly reflects its income. Respondents having elected to file on the accrual basis on which their accounts were kept, may not now revert to the cash basis and recover $2,719,159.16 in taxes paid on their original returns without establishing that their accrual basis of accounting did not reflect true income. Their right to have their taxes computed on the cash basis depends, not upon the action of the Commissioner, but upon whether the basis upon which their books of account were kept and their income returned correctly reflects true income.

Section 13 (d) clearly does not give the Commissioner the arbitrary right to reject a return filed upon the basis upon which a taxpayer's accounts are kept. He may so reject a return only where the basis used does not reflect true income. Conversely a taxpayer would not be entitled to have taxes, returned upon the basis upon which its books of ac-

count are kept, computed on the cash receipts and disbursements basis unless that basis did not in fact reflect its income, and their being no finding that the respondents' accrual basis did not correctly reflect true income, it is submitted that the findings of the District Court are insufficient to support the judgments.

The Circuit Court of Appeals in its opinion (R. 262) assumed that the District Court had made such finding. This assumption, however, does not supply this defect. In fact, respondents expressly disclaimed any intent of having the lower court pass upon this issue, their contention being that the Commissioner's action controlled rather than the fact as to whether the basis upon which respondents kept their accounts reflected their true net income. (R. 51, 52.)

CONCLUSION

It clearly appears from this record that neither the returns as made by these corporations nor the computation used by the courts below in determining the net income clearly reflects the true net income of these respondents for the year 1917. The fundamental requirement of the statute is that, whatever basis of accounting be used, the true income must be disclosed by the return. In this fundamental particular, the courts below have committed error and permitted these respondents to pay a tax based not upon their actual income but upon an amount artificially produced and erroneously

called their income. They have done this by treating the so-called "inventory constant account" as a real liability reflecting a part of the cost of goods sold,whereas in fact it represents no existing obligation of the corporation. They have said that the creation of a contingent reserve and the treatment of such a reserve as a real liability constitutes a system of accounting and thus have permitted more than $11,000,000 of admitted income to escape taxation in this year. It, therefore, is respectfully submitted that writs of certiorari should be issued.

CHARLES E. HUGHES, Jr.,
Solicitor General.
MABEL WALKER WILLEBRANDT,
Assistant Attorney General.
MILLAR E. MCGILCHRIST,
Special Assistant to the Attorney General.

JUNE, 1929.

APPENDIX

United States District Court, Southern District of New York

AMERICAN CAN COMPANY, PLAINTIFF
against
FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE of the United States for the Second District of New York, defendant

MISSOURI CAN COMPANY, PLAINTIFF
against
FRANK K. BOWERS, COLLECTOR, ETC., DEFENDANT

AMERICAN CAN COMPANY OF MASSACHUSETTS, plaintiff
against
FRANK K. BOWERS, COLLECTOR, ETC., DEFENDANT

AMERICAN CAN COMPANY OF UTAH, PLAINTIFF
against
FRANK K. BOWERS, COLLECTOR, ETC., DEFENDANT

OPINION

(October 26, 1928)

GODDARD, *District Judge:*

These four actions were brought by the American Can Company, a New Jersey corporation, and

three of its subsidiaries, Missouri Can Company, American Can Company of Massachusetts, and American Can Company of Utah, to recover amounts which they paid on March 15, 1924, as Federal income and excess-profits taxes for the calendar year 1917 with interest from the date of payment. These amounts were paid under protest as a result of additional assessments made in accordance with letters of the Commissioner of Internal Revenue to the plaintiffs, dated March 7, 1921. The amounts claimed by the various plaintiffs are as follows:

American Can Company, $3,874,911.37, with interest at the rate of 6% per annum from March 15, 1924;

Missouri Can Company, $11,489.53, with interest at the rate of 6% per annum from March 15, 1924;

American Can Company of Massachusetts, $13,057.83, with interest at the rate of 6% per annum from March 15, 1924; and

American Can Company of Utah, $3,477.54, with interest at the rate of 6% per annum from March 15, 1924.

Upon stipulation of counsel the four actions were tried together before a jury of one and after all the testimony had been presented, both sides moved for the direction of verdicts.

On March 29, 1918, the returns for companies were filed, under section 13 (d) of the Revenue Act of 1917, showing a consolidated net income of $17,944,400.46 (including $60,010.50 as dividends). After an audit by the Commissioner of Internal Revenue, their income was increased by $1,283,721.37 so that it amounted to $19,278,121.03, and the tax paid. Later, a reaudit was made by the Com-

missioner and as a result he redetermined their income and by his communications to them on March 7, 1921, increased their taxable net income from $19,278,121.03 to $24,949,668.51 (including $60,010.50 as dividends).

The American Can Company and its subsidiaries were manufacturers of cans and other containers made largely from tin plate, and it was necessary for them to maintain a supply of tin plate so as to fill their orders promptly. In 1916, tin plate cost them $3.80 per base box. Some of this they carried over into 1917 and they received further shipments of it at the rate of $3.60 per base box under previous contracts. In the early part of 1917, the price had risen sharply in price and it sold at $7 per base box, and the plaintiffs charged their customers with the tin plate consumed in the manufacture of their finished product at the current market price of $7 per base box of tin plate at the time of the manufacture, irrespective of the price paid for it, so that upon all of such sales they realized an inventory profit of $3.40 per base box during that year besides their normal manufacturing profit. This profit was not reported as income in their returns, the plaintiffs taking the position that this price of $7 per base box was abnormally high because of war conditions and that when that temporary condition was over, prices would drop sooner or later to a more normal level and that as tin plate was the basic material for making cans and containers, it was necessary for them to carry large stocks of it to meet promptly the requirements of customers for their manufactured products; and that to value their stock of tin plate at the current high cost or market under such a situa-

tion was unsound; and that to avoid risk of overstating their incomes and overvaluing their assets they accordingly established an "Inventory Constant Account" and carried their normal stock of tin plate at a constant figure.

This "Inventory Constant Account" was created by certain journal entries. In the instance of the American Can Company—a journal entry was made on January 31, 1917, debiting an account designated "cost ledger" and crediting an account called "inventory write-up" in the sum of $5,403,905.79. A further journal entry was made on the same date debiting various "finished products" accounts and crediting "inventory write-up" in the sum of $647,572.26. These entries, although made on January 31, 1917, were effective as of January 1, 1917. The effect thereof was to increase the value of the opening inventory, in the case of the first journal entry, of inventory of raw materials and goods in process, and in the case of the second journal entry, of inventory of finished products. Part of this "write-up" to the extent of $4,722,000 was transferred to a reserve account called "Inventory Constant." This was done by a journal entry debiting the account called "Inventory write-up" and crediting the account called "Inventory Constant" in the sum of $4,722,000. Mr. Green, the Treasurer of the American Can Company, testified:

> Our inventories were written up on the 1st of January on the $7.00 basis for tin plate, and our operations were charged at that price right straight through the year, and all of the operations and the accounts on our general ledgers were carried at that

figure and the profit and loss and the inventory at the close of the year from a profit and loss standpoint was figured on the same basis. Now that had the effect of decreasing the profits for 1917 to the extent of the constant * * *

The tin plate constant account was set up on our books as applying against the inventory. At the close of 1917, when the balance sheet of the company was made, the $4,722,000 was deducted from the inventory as reported on the high basis, and on that basis the difference between the assets and the liabilities of the company, representing the difference in the surplus, agreed with the profit and loss as figured from a profit and loss standpoint.

* * * * *

Q. So that that was an increase in cost that was not actually sustained by the company, and had the effect of reducing income, did it not? A. It did.

Entries and "write-ups" of like nature were made by the several plaintiff companies, the total amount being $5,671,500. The Commissioner of Internal Revenue ruled that this "Inventory Constant Account" could not be included in the cost of the merchandise sold when deducting the cost from the selling price in computing income, and his reasons in his letter of March 7, 1921, to the American Can Company relative to its item of $4,722,000 are characteristic of those stated to the several plaintiffs respecting similar items in their returns, and are—

(a) This item represents a charge to costs of raw material put in process over the actual cost at which same was inventoried at December 31, 1916. The credit was placed to "Inventory Constant" account. The entry was made in anticipation of a drop in the market at some future date, when a loss would occur on account of high priced inventories at hand.

For income tax purposes, all income must be returned in the year in which realized and if the market should slump at a future date, the loss would be taken in the year in which realized.

The entry referred to above would result in an elimination of profits realized through rise in market values, and therefore, has been disallowed.

It is the taxes which were assessed upon these increases in the respective incomes resulting from the disallowance of this item by the Commissioner, which the plaintiffs now seek to recover after paying it under protest.

The plaintiffs kept their books on an accrual basis of accounting as distinguished from a basis of cash received and disbursed, and filed their returns on such basis for 1917 and all previous years; also 1918. The letters of the Commissioner contain no specific rejection of the returns filed by the plaintiffs or of the accrual basis on which they were made, and the plaintiffs filed no returns for 1917 on the cash basis. The plaintiffs contend that the action of the Commissioner in disallowing this item constituted a rejection of the basis upon which their books were kept and their returns filed, and that consequently

he had no power to redetermine their incomes or to assess taxes upon any basis other than the basis of actual receipts and disbursements. The defendant insists that there was no rejection of the basis on which the returns were filed and that the Commissioner merely disallowed an improper deduction. Statements prepared by the plaintiffs and received in evidence during the trial show that their incomes for 1917, on the basis of actual receipts and disbursements, aggregated $13,231,054.52 (including $60,010.50 as dividends).

Although the record contains quite an array of figures, the real question is whether the act of the Commissioner in eliminating the " Inventory Constant Account" is to be regarded as a rejection of the "basis" upon which the plaintiffs filed their returns and upon which their books were kept, thereby entitling them to file returns on a cash basis for the year 1917, with the result that as their returns for 1916 and 1918 were filed on the basis on which their books were kept or an accrual basis, a very substantial amount of income would escape taxation.

The Acts of Congress which imposed and determined the amounts of the Federal income and excess-profits taxes for 1917 are the Revenue Act approved September 8, 1916, and the Revenue Act approved October 3, 1917. These two Acts together constitute the Revenue Act of 1917. The Act of October 3, 1917, continued some of the provisions of the Act of September 8, 1916; amended others and added some new provisions. While the Act of 1917 changed the rates and method of computing taxes, it did not change materially the method of

determining the amount of the income, subject to taxes. The Revenue Act of 1917 prescribes the basis of actual receipts and disbursements generally described as the cash basis for determining the amount of income subject to taxes. However, under section 13 (d) corporations (section 8 (g) similarly applied to individuals) keeping their accounts on a basis other than that of the cash basis were permitted to file their returns on such other basis, provided it truly reflected the income. Section 13 (d) reads as follows:

> A corporation, joint-stock corporation, or association, or insurance company keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.

The plaintiffs filed their returns under this section.

The tin plate, which cost the plaintiffs $3.60 per base box, was at the end of January, 1917, written up in their inventories as of January 1, 1917, on a valuation of $7 per base box; this difference of $3.40 was carried to their "Inventory Constant Account." The result of this was to inflate the valuation of their tin plate, and, although the companies benefited to the extent of $3.40 per base box, it was not accounted for in their return. Reduction

of profits may be effected by artificially appreciating an opening inventory or by depreciating a closing inventory. The scheme adopted by plaintiffs might be described as an indirect method of claiming a depreciation to which they were not entitled irrespective of the basis upon which their books were kept or their returns filed. The basis theory upon which the plaintiffs' books were kept was in the nature of an accrual basis, and this was not disturbed by the Commissioner; he merely disallowed as a deduction an item which was shown on their books. Gain derived from the sale of assets is income. *Doyle* v. *Mitchell,* 247 U. S. 179; *Stratons Independence* v. *Howbert,* 231 U. S. 399.

Plaintiffs concede that the Commissioner has the authority to correct a return filed upon the cash basis, but insist that section 13(d) creates an exception, and that when a return is filed under this section that the return is immune from any adjustment by the Commissioner and that he must either reject it or accept it as it stands; that he has no authority whatsoever to do anything else.

While it is undoubtedly true that the Commissioner must accept the basis upon which the corporation keeps its books and files its return, or in the alternative require it to file on the cash basis, if it is able to do so, and that he can not compel it to change its basis other than to a cash basis, I do not agree that he is without power to audit a return and adjust items in accordance with the basis upon which it is filed or disallow improper deductions or to allow proper deductions and credits which it may appear the taxpayer rightfully should have had. The plaintiffs' contention as to the limitation of the Commissioner's power over a return filed

under section 13(d), it seems to me, can not be correct. If it were so, corporations which were unable to file a return on the cash basis—and it is well known that there are many so situated because of the nature of their business and records—might escape paying taxes. For if the plaintiffs' position is right, such a corporation, when compelled to file under section 13(d) because unable to file on the cash basis, could then file a return under 13(d) which did not reflect its true income, and the Commissioner would have to accept it without corrections, as it follows that if the Commissioner has no authority to correct a return filed under section 13(d) he would lack authority to correct a return filed under such circumstances. The Supreme Court, in *United States* v. *Anderson,* 269 U. S. 422, held that the Commissioner had the authority to correct a return filed by a corporation upon the basis on which it kept its books (section 13(d)) in a case where it was unable to file on the cash basis; therefore, the Court must have regarded the Commissioner as having the power to correct returns filed under Section 13(d) for certainly there is nothing in the statute which gave the Commissioner authority over that particular return that he did not have in respect to all returns filed under section 13(d). Nowhere in the statute is there found a limitation of his power as to such returns. It seems to me that the reasonable construction of 13(d) wherein it provides that the books and return must reflect income, in that the taxable income must be computable from the basis of accounting adopted, not that such a return is immune from adjustments by the Commssioner in accordance with the basis used.

I think that section 13(d) must be read in the light of the other provisions of the Revenue Act, and that the definitions of what is taxable net income under section 12(a) are applicable to all returns, though, of course, all of them may not be applicable to every return. This is the clear inference from the statements of Mr. Justice Sanford on pp. 100, 101, of the Court's opinion in *American National Company* v. *United States,* 274 U. S. 99. If the definitions of what is taxable net income under section 12(a) are not applicable to all returns, there would be much confusion and, moreover, it would mean that the Commissioner and not Congress had the power of defining what was the taxable net income of a corporation filing under section 13(d). In *United States* v. *Anderson* (supra), p. 437, Mr. Justice Stone states:

> While Sec. 12 (a) taken by itself would appear to require the income tax return to be made on the basis of actual receipts and disbursements, it is to be read with section 13(d) which we have quoted and which obviously limits in some respects the operation of section 12(a) by providing in substance that a corporation keeping its books on a basis other than receipts and disbursements may make its return on that basis provided it is one which reflects income.

This would indicate that the exception provided in section 13(d) applied only to the extent of permitting a corporation to file its return on the basis on which its books were kept, but does not exclude the definitions of income defined in section 12(a).

Section 10 levied a tax upon "the total net income * * * received * * * from all sources by every corporation * * * organized in the United States" except those organized and operated exclusively for religious, charitable, educational purposes, and the other expressly exempted under section 11.

12(a) makes no reference to accounts receivable, accounts payable, inventories, for the obvious reason that these are not used when making a return on the cash basis, but it does list the various deductions which were allowed, such as ordinary and necessary expenses, losses, interest on indebtedness, taxes, and the like.

13(a) which dealt with the filing of returns provided that "the tax shall be computed upon the net income as thus ascertained," namely—by deduction from the gross income received from all sources the various deductions permitted under 12(a).

14(b) provides "When the assessment shall be made as provided for in this title, the returns, together with any corrections thereof which may have been made by the Commissioner, shall be filed * * *."

From the above it would appear that the standard of what is income "from all sources by every corporation" does not change, although the basis of keeping their books and filing their returns may differ; some adopting the method or basis of accounting on cash received and cash disbursed; others using a method or a basis of accruing their receipts and disbursements. Section 13(d) recognized that some corporations found it more practical to keep their books on some other basis than that of cash received and disbursed, and permitted them latitude as to the

precise basis which might be used in keeping their books and in filing their return, but it did not grant to them the exceptional power to say what was income and what was not income, as I read the statute. Where a corporation was in a position to do so, it was permitted to elect whether it would file on the cash basis or under 13(d). Having elected, all the items must be accounted for in a manner consistent with such basis, and if the basis adopted does not "clearly reflect its income," the Commissioner may require them to file on the cash basis, if it is possible for them to do so. But if the basis is a fair one, the Commissioner has the authority under the Act to make any such corrections in the items as may be necessary to make them conform on the basis adopted by the taxpayer so as to reflect income as defined for corporations.

In *United States* v. *Anderson* (supra) the accounts were kept and the return was filed on the basis of accruing all their receipts and disbursements and they accrued on their books in 1916 their munitions taxes for 1916 which were taxable and paid in 1917. They made their returns for 1916 and 1917 on the basis of their books except that they deducted their munitions taxes from their income for 1917 instead of 1918. The Supreme Court sustained the ruling of the Commissioner that their munitions taxes should have been deducted from their 1916 income instead of their income for 1917, and his adjustment of their taxes accordingly. The corporations were not able to make their returns on the basis of actual receipts and disbursements, and the Court held that as their accounts were kept on a basis which clearly reflected their incomes, they were required to make their returns on the basis

of their own books, and that the adjustments made by the Commissioner merely had the effect of making their returns accord with their own books of account. Counsel for plaintiffs rely upon this case as supporting the contention that where a corporation has filed its return on the basis upon which it keeps its books under section 13 (d), the Commissioner has no right to amend or correct it, and his only alternative is to require the corporation to file on a cash basis; that only in the event that the corporation is unable to file a return on the cash basis may the Commissioner amend or correct the return. Perhaps the language of Mr. Justice Stone, on pages 437, 438 is susceptible of this inference when standing alone, where he discusses the Treasury Decision 2433 and the right of the Commissioner to require the return to be made on the basis of receipts and disbursements if the return failed to reflect income. But it seems clear conclusion from his entire opinion that the Commissioner has the option of requiring the corporation to file a return on a cash basis if the basis on which the return was filed does not reflect true income. In other words, if the basis upon which the return is filed is not susceptible of properly reflecting income, then the Commissioner may require them to file on the cash basis; but if the accounts are kept and the return filed upon a basis which will reflect income but does not, because of incorrect items, the Commissioner may make such adjustments as to enable him to compute taxable net income in accordance with the corporation's basis or method of accounting. Obviously, the Court did not hold

the view that the Commissioner had no power to amend or correct a return filed under section 13 (d). Plaintiffs' position must be taken then that while the Commissioner had the power to audit or correct returns filed under 13 (d), its use was limited to special instances. However, if the power exists at all, and concededly it does, under no logical theory or construction of the statute is there support for the idea that the Commissioner's authority was thus confined. He either had the power over all returns filed under 13 (d), or he had power over none of them. The statute permits no middle ground.

The plaintiffs urge that the effect of the words of section 13 (d) "the tax shall be computed upon its income *as so returned*" was to substitute in a case like the one at bar for the purpose of computing the tax the income *as returned* by it instead of its income ascertained as prescribed by section 12(a). And further, that it is the *amount* of the income and not the basis which "as so returned" applies to so that the Commissioner must accept the amount, otherwise he rejects the basis. I think the words "as so returned" refer to the basis for the reasons discussed above, and again in the *Anderson* case, supra, the tax there was not computed on the amount "as returned" but upon the income "as so returned" on their basis after the Commissioner of Internal Revenue had disallowed a deduction claimed in the return.

Counsel for plaintiffs also contend that aside from any question with respect to the powers of the Commissioner under the Revenue Act of 1917, Congress had no power under the 16th Amendment

of the Federal Constitution to levy taxes upon income which had accrued but was not actually received by the taxpayer, so that regardless of any attempt on the part of Congress to clothe him with this authority, he had no power to redetermine the income of the plaintiffs upon any basis other than the basis of actual receipts and disbursements. This contention seems to me to be answered by a reference to the decision and the opinion in the *Anderson* case, supra, where it was pointed out that true income is to be determined by deducting from gross income during the year the total costs and expenses attributable to the production of that income during the year. This is the essence of accrual basis of accounting.

Moreover, in *Brushaber* v. *Pacific R. R.*, 240 U. S. 1, it was held that it was not the 16th Amendment which conferred upon Congress the general power to impose tax upon income, which Congress already had, but that the purpose of the 16th Amendment was to relieve Congress in imposing income taxes in so far as they might be held to be direct taxes from the burden of apportioning such taxes according to population. See also *Bowers* v. *Kerbaugh-Empire,* 271 U. S. 170; *Eisner* v. *Macomber,* 252 U. S. 189.

My conclusion is not in accord with Judge Bodine's decision in *American Can Company* v. *United States,* 20 Fed. (2d) 970, but it is consistent with that of Judge Westerhaven in *Aluminum Castings Co.* v. *Routzahn,* 24 Fed. (2d) 230, where a corporation had filed its return for 1917 under section 13 (d) and the Court sustained the right of the

Commissioner to correct it so as to properly compute the tax due on the basis upon which the return had been filed by deducting from the 1917 return $150,000 paid for munitions taxes in 1917 but which had accrued in 1916.

Accordingly the jury is directed to render verdicts in favor of the defendant.

O